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Housing – Europe

COVID-19 accelerates housing market trends, exacerbating wealth inequalities

Summary

COVID-19 will accelerate fundamental shifts in the housing market in Europe, with affordability declining despite falling prices, demand for social housing and rental market regulation increasing. Housing preferences are shifting in part from urban areas to smaller cities and suburbs, although cities remain attractive.

» **House prices will decline because of COVID-19, particularly in tourism-dependent countries.** European house prices have remained stable in 2020, but we expect prices to decline in most countries in the aftermath of COVID-19, given the severe economic downturn triggered by the pandemic. Declining house prices will be credit negative for nonperforming loan (NPL) securitisations. European banks will face higher credit costs because of increasing NPLs, but robust capital reserves will mitigate this risk. We expect no credit impact for housing companies operating in highly regulated rental markets like Germany.

» **Housing affordability will worsen for young and low-income population groups.** Whilst house prices will decline, housing affordability will worsen for many prospective buyers post COVID-19, because of reduced earnings and access to finance. Debt availability will be limited because of stricter underwriting. This will affect young and low-income groups in particular, exacerbating wealth inequalities.

» **Demand for social housing and rental market regulation will increase.** We expect demand for social housing will increase, given rising unemployment and income losses amid the economic downturn. Rental market regulation will also likely increase to protect vulnerable tenants. This will lead to an increase in arrears for housing associations and local governments in the short-term and constraints in respect of government funding in the medium-term.

» **Housing demand will shift in part from city center locations to suburbs. Cities will nonetheless remain attractive.** The growing prevalence of remote working and the decrease in affordability because of COVID-19 will accelerate the shift in demand for housing away from urban areas towards smaller cities and suburbs. House prices in big cities will recover more slowly than other parts of each country, in contrast to what happened after the global financial crisis.

House prices will decline because of COVID-19, particularly in tourism-dependent countries

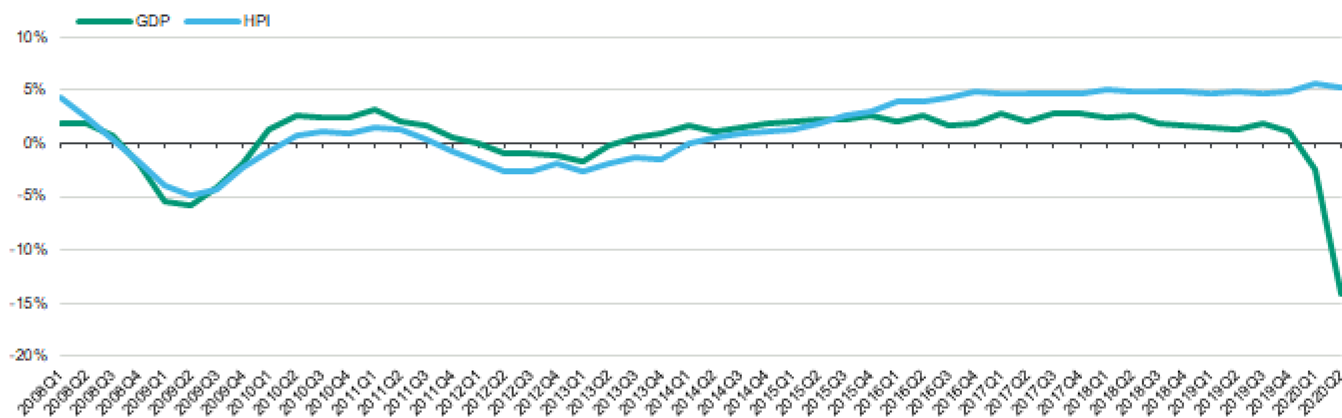
COVID-19 has triggered a severe economic downturn in Europe, with GDP contracting on an unprecedented scale and unemployment rising. European house prices have remained stable in 2020 to date because of policy support, but given the extent of the economic downturn, we expect prices will fall in most European countries in the aftermath of the pandemic. The decline in 2021 will be followed by a recovery expected to take hold from 2022, on the back of a wider post-crisis economic rebound.

Historically, residential transaction volumes and prices across Europe have closely followed economic activity and prices declined significantly following the global financial crisis, as Exhibit 1 shows. This was particularly pronounced in countries like Spain, Ireland and the UK (see Appendix). In 2020, government policy support - including income support measures and mortgage payment moratoria - have shielded house prices since the virus outbreak.

The unprecedented GDP decline in 2020 and ongoing uncertainty about the pandemic will be negative for households' earnings, appetite for borrowing and housing demand. While we expect the Euro area economy will recover in 2021 (4.7% GDP growth), it will take time for economic activity to return to pre-pandemic levels in all sectors and unemployment will remain elevated across major countries. We therefore expect house prices will decline in many western European countries in 2021, given that recessions have historically reduced housing demand because of lower disposable income, job losses and uncertain sentiment. The extent of price declines will depend on supply and demand dynamics in specific markets and it will be softened by the unprecedented fiscal income-supporting measures implemented during the crisis.

Exhibit 1

European house price changes are closely linked to GDP movements
Nominal GDP and house price index (HPI), growth vs previous year



Note: HPI shows aggregated EU 27 data.
Source: Moody's Investors Service, based on Eurostat data

House price risks will differ between European countries

House price risks will differ between European countries and regions in the aftermath of COVID-19. Risks will be highest for southern European countries with relatively high dependence on industries such as tourism, as well as the UK, where Brexit is compounding COVID-19-related house price pressures.

Southern Europe's exposure to tourism will raise house price risks

In Southern Europe, economies are more dependent than other European countries on sectors such as hotels, restaurants and tourism, which have been hit hard by the economic fallout from COVID-19. For example, approximately 11% of Spanish GDP, 13% of Italian GDP and 7.3% of French GDP is related to tourism, whilst this accounts for only 4.5% of German GDP. This will raise house price risks in Spain, Italy and France in the wake of COVID-19. Within these countries, coastal regions depend more on tourism than other areas (Exhibit 2). Depending on the time it will take for tourism to reach pre-COVID-19 levels, we would expect residential stock in these

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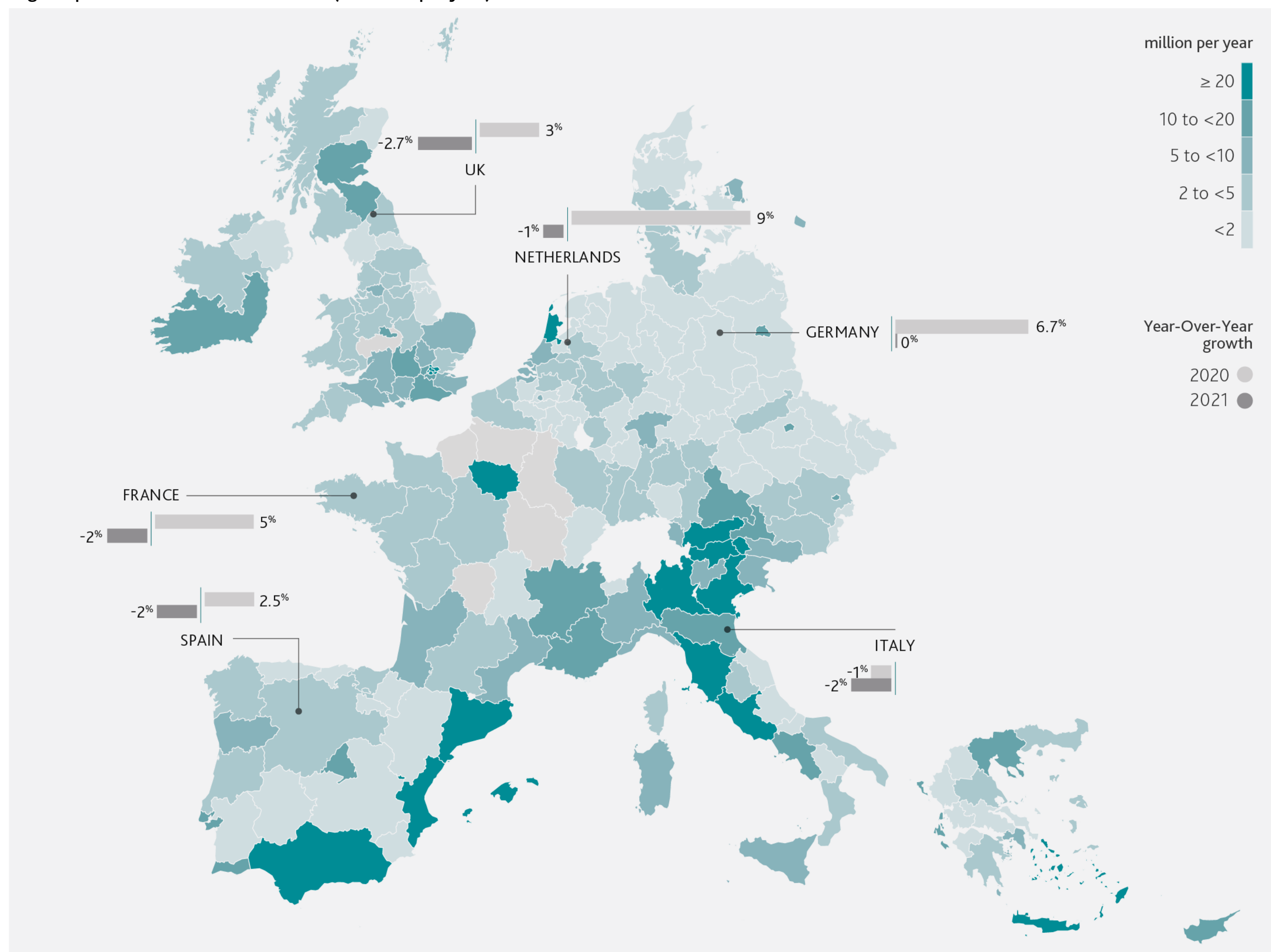
areas to shift from short-term holiday lets to the long-term lettings markets, leading to oversupply in the rental market and ultimately adding to house price risks.

Exhibit 2
Southern Europe and the UK will suffer bigger house price declines
Nights spent at tourist accommodation (in million per year) and HPI forecast



Sources: Moody's Investors Service, based on Eurostat data. HPI forecasts are based on Moody's Investors Service projections

Brexit will add to COVID-19 house prices risks for the UK

In the UK, the house price outlook is more negative than for other European countries, given the economic disruption of Brexit in addition to COVID-19.

UK house prices actually increased to record highs between July and October 2020, immediately after the economy recorded its deepest ever contraction in the second quarter of 2020. Prices increased because of pent-up demand after lockdowns eased, as well as the government's stamp duty land tax (SDLT) payment holiday scheme, which will end in March 2021.[1]

However, given the economic and labour market downturn and Brexit uncertainty, UK house price increases are unlikely to last. As prices decline, it will become more difficult for highly-leveraged UK borrowers to refinance mortgages.

Risks will be lower in Germany and Nordic countries

In Germany and Nordic countries, house price risks will be lower than in other regions in the aftermath of COVID-19. In these countries, rental market regulation results in a structural undersupply of apartments, which will support prices in the wake of the pandemic. The social security systems in Germany and Nordic countries are also strong, which will support house prices. As a result, we expect that there will be little adverse credit consequences for large corporate issuers that provide affordable rental apartments in these countries. House price risks will be higher outside of the affordable housing sectors.

Declining house prices will increase securitizations' loss severities and reduce banks' abilities to resolve increasing NPLs

Declining house prices are credit negative for residential mortgage-backed securities (RMBS), because increased loan-to-value (LTV) ratios will result in higher refinancing risk and ultimately in higher loss severity. Structural features and portfolio characteristics mitigate these risks for RMBS, especially with prime owner-occupied collateral.

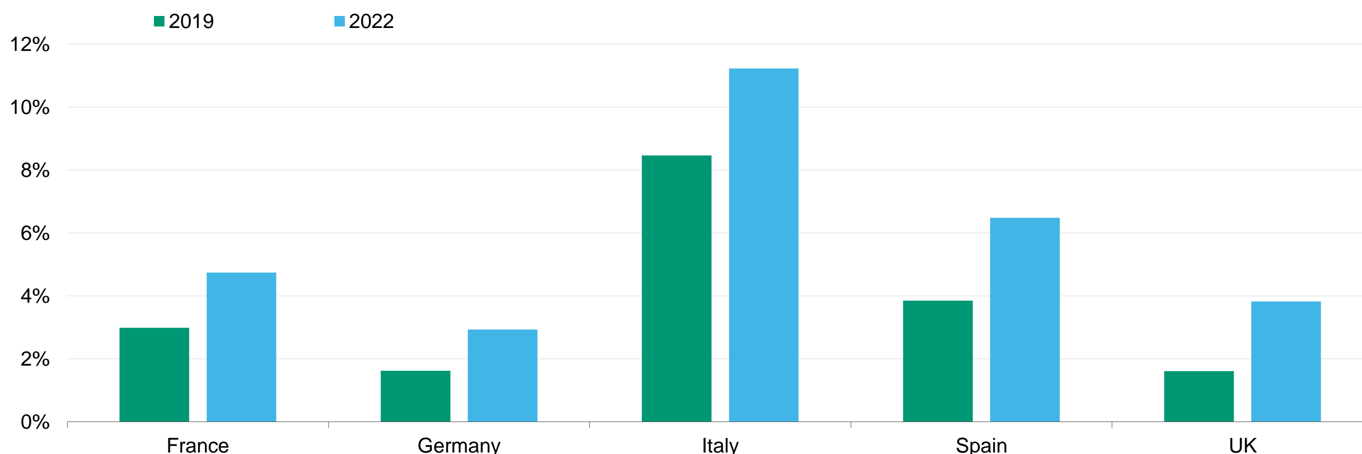
Declining house prices are particularly credit negative for NPL securitisations, because they reduce recovery prospects given the higher leverage in such portfolios. Recovery timing will increase because of lock-down periods, market liquidity and the required price adaption by seller and buyer for a successful asset realisation.

Exhibit 3 shows that we expect banks' NPL ratios to increase in major European countries in 2022 compared with 2019. European banks' robust capital reserves will mitigate this risk. We expect problem loans in major European economies to peak at roughly twice their pre-COVID-19 levels, though new furlough schemes and moratoria will push back the timing of this. NPLs will mostly increase because of problems loans in sectors particularly exposed to COVID-19 disruptions, like small and medium sized corporates, commercial real estate and unsecured consumer lending, and less because of mortgage loans to retail clients. The key challenge for the banking sector will be to deal with higher credit costs without impairing capital positions, a task that will be most difficult for banks with weak core profitability, or banks with concentrated exposures to COVID-19 hit sectors, or both. Overall, we expect European banks will be able to absorb higher credit costs if there is a short-term dip in house prices. If house prices decline in the medium term, the negative credit implications would be more severe.

Exhibit 3

NPLs will increase in Europe

Baseline scenario NPLs as a % of gross loans (2019 vs 2022)



Source: Moody's Investors Service

Housing affordability will worsen for young and low-income population groups

Whilst house prices will decline, there will be a simultaneous reduction in household earnings and lower debt availability. As a result, housing affordability will worsen for young and low-income groups even as prices decline.

Incomes will decline, worsening affordability

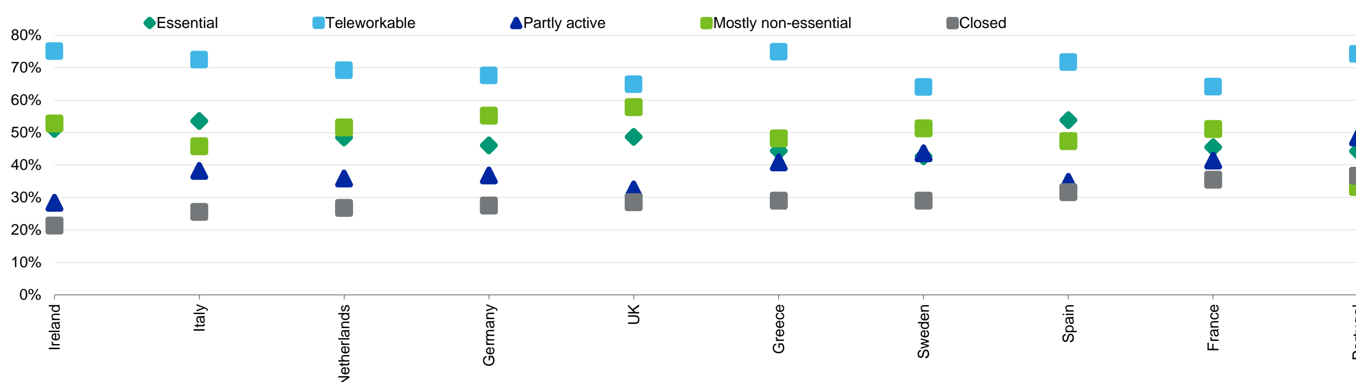
Young and low-income cohorts are more likely than other population groups to lose jobs and income because of the economic fallout from COVID-19, given that these groups account for a large proportion of employees in industries facing significant disruptions because of the pandemic, such as hospitality, retail and tourism.

The jobs that are most disrupted by COVID-19, such as restaurant and hotel roles, have the lowest average wages, as Exhibit 4 shows. In contrast, jobs that can be performed remotely, including most professional services roles, are mostly at the higher end of the income range.

Exhibit 4

COVID-19 has significantly disrupted low-income employment sectors

Average wage percentile, by job category



Note: Job category descriptions: Essential - food production, pharmaceutical production, utilities, transport, health (fully active). Teleworkable - education, public administration, professional services (insurance, finance, accounting, programming, research, design, advertising, telecommunication) (fully active). Partly active - retail, chemicals and paper manufacturing (mostly essential, not teleworkable). Mostly non-essential - leisure, hotel, restaurants, manufacturing, construction, machine and computer repairs (partly active, not teleworkable). Closed - hospitality, accommodation, leisure and recreation services, personal services, travel agencies (non-essential). For further details, see The COVID confinement measures and EU labour markets

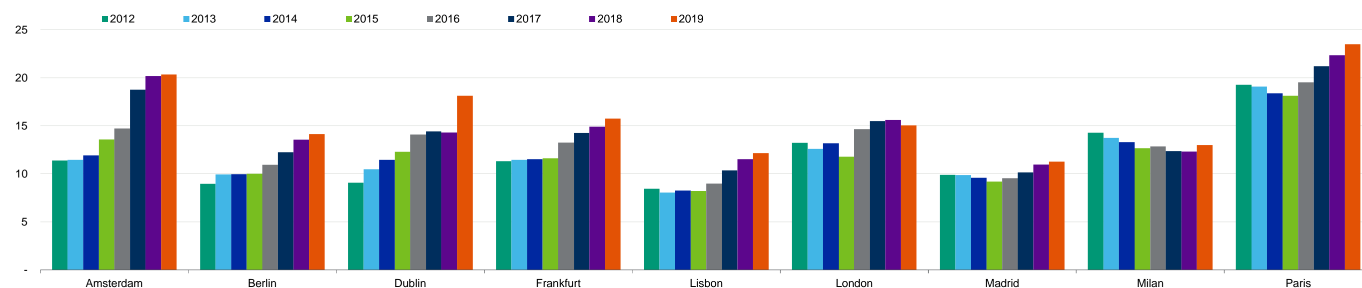
Source: Moody's Investors Service, based on European Commission data

Even before the pandemic, housing affordability was worsening in Europe, with home purchase deposit requirements becoming increasingly challenging for low-income buyers, given prevailing house-price-to-income ratios. The economic effects of the pandemic will exacerbate this issue, particularly for young and low-income home buyers, because reduced incomes and lower debt availability will outweigh declining house prices. In Paris, the average home buyer needed around 23 times the average annual disposable income to purchase a 70 square meter property in 2019, compared with 11 times in Madrid, as Exhibit 5 shows.

Exhibit 5

Housing affordability has worsened in many European cities

Cost of 70sq meter property, in times of average annual disposable income



Note 1: Average disposable income for each city based on Eurostat data.

Note 2: Average house price calculated as average price per square meter times 70

Source: Moody's Investors Service, based on Eurostat data

Stricter underwriting criteria will restrict access to finance for some borrowers

In some European countries, lenders have tightened underwriting criteria in their immediate response to the worsening macroeconomic environment triggered by COVID-19. Tighter underwriting is positive for loan credit quality, but it will reduce the supply of finance for weaker borrowers such as young and low-income households, exacerbating housing affordability issues for these groups.

We expect banks' lending will focus on prime borrowers whilst banks have raised credit standards as an interim response to the pandemic in anticipation of heightened price risk prior to a rebound in the medium-term. The shift to a gig economy means that a rising proportion of employment is short-term and on a self-employed basis, without company protection in events such as COVID-19. At the same time, underwriting criteria for mortgage lending focusses on evidence of salaried or otherwise stable incomes, which does not match the evolution in this segment of the job market. As a result, debt finance availability for self-employed and temporary workers will be limited and subject to mortgage rates and deposit requirements that are higher than for more traditional borrowers.

Banks have remained fairly strong since the coronavirus outbreak and have continued to provide credit, albeit more selectively. For the Euro area, credit standards for housing loans continued to tighten significantly in the third quarter, related mostly to the deteriorating economic outlook. The rejection rate for housing loans increased to 8% in the third quarter 2020, from 4% in the second quarter, athough there was a massive increase in demand.[2]

For the UK, second quarter data signals both a decline in supply and demand for housing loans, because of tighter credit conditions.[3] In the UK, lenders have recently increased interest rates for high LTV loans more than for lower LTV loans[4], squeezing first-time home buyers, who are particularly dependent on these. In addition, many lenders have reduced high LTV lending in response to the worsening economic environment. During the first half of 2020, UK mortgage approvals for first-time buyers declined 6% compared with the same period a year earlier, with first-time-buyer mortgage volumes dropping to around 18% of total mortgage lending volume in the second quarter of 2020, the lowest since the first quarter of 2016.

Demand for social housing and rental market regulation will increase

We expect demand for social housing will increase in the aftermath of COVID-19, given rising unemployment and income losses amid the economic downturn in Europe. Rental market regulation will also likely increase, with governments legislating to protect tenants hurt financially by the economic downturn.

Demand for social housing will increase

As incomes decline amid the economic downturn in Europe and temporary government wage support schemes taper off, renting will become less affordable for many households. As a result, we expect demand for social housing will rise in the aftermath of COVID-19.

However, fiscal pressures at the sovereign level will limit capacity to extend temporary income support schemes, increase income support via benefits systems, or fund new social housing above what is already planned. New supply of social housing will not keep pace with increased demand, which will exacerbate social housing shortages.

Arrears may increase for housing associations and local governments in the short-term as rental affordability declines. However, the credit implications will be minimal for housing associations, given that they benefit from countercyclical demand and stable operating cash flows underpinned by government-backed rental income.

Rental market regulation will increase

European governments may increasingly turn to regulation to support tenants in the aftermath of the pandemic, as some did after the 2008 financial crisis.

European governments' funding of emergency COVID-19 support measures, in combination with the negative outlook for raising tax, will create budget constraints and reduce governments' capacity to provide direct fiscal support to tenants. These budget constraints increase the likelihood that governments will use regulation to protect tenants.

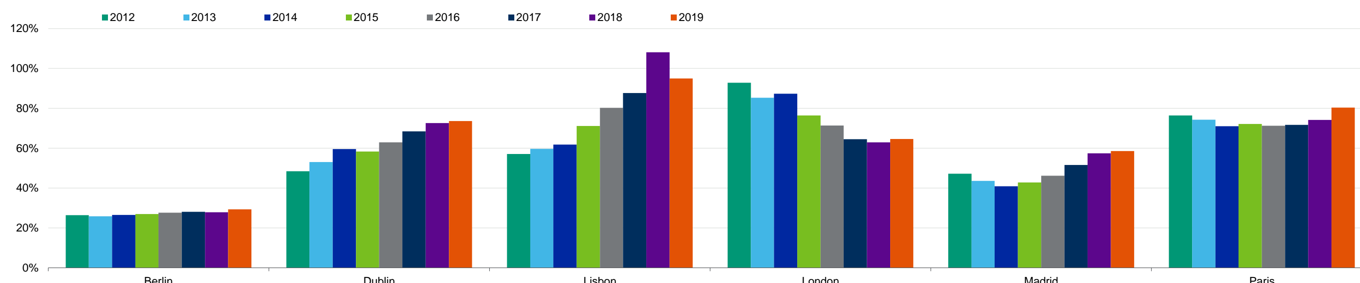
In recent years, some European countries have adopted more renter-friendly regulation. For example, Ireland introduced rent controls, France limited rent increases and Spain made the eviction process more challenging. In Germany, where the rental market is already heavily regulated, there was political debate about tighter regulation even before the COVID-19 outbreak.

Rent affordability was worsening in many European cities before COVID-19, as Exhibit 6 shows. This was particularly the case in Dublin, where the average rent was almost 80% of average salary in 2019, reflecting low supply and low unemployment, and Lisbon, where the figure was close to 90%, given strong tourism-related property demand. In Berlin, the average rent was below 40% of average salary, reflecting rent controls. The data showed in Exhibit 6 may be less representative for some cities as it takes into consideration the average rent for a 2 bedroom apartment in relatively affluent areas.

Exhibit 6

Rent affordability is worsening in some European cities

Rent as % of average salary, by city



Note 1: Average gross income for each city based on Eurostat data.

Note 2: Average rent for a 2 bedroom apartment based on Eurostat data. The neighborhoods included in the sample are classified as residential affluent areas.

Note 3: The data does not consider multiple incomes that would improve the ratio.

Source: Moody's Investors Service, based on Eurostat data

Housing demand will shift in part from city centre locations to suburbs. Cities will nonetheless remain attractive.

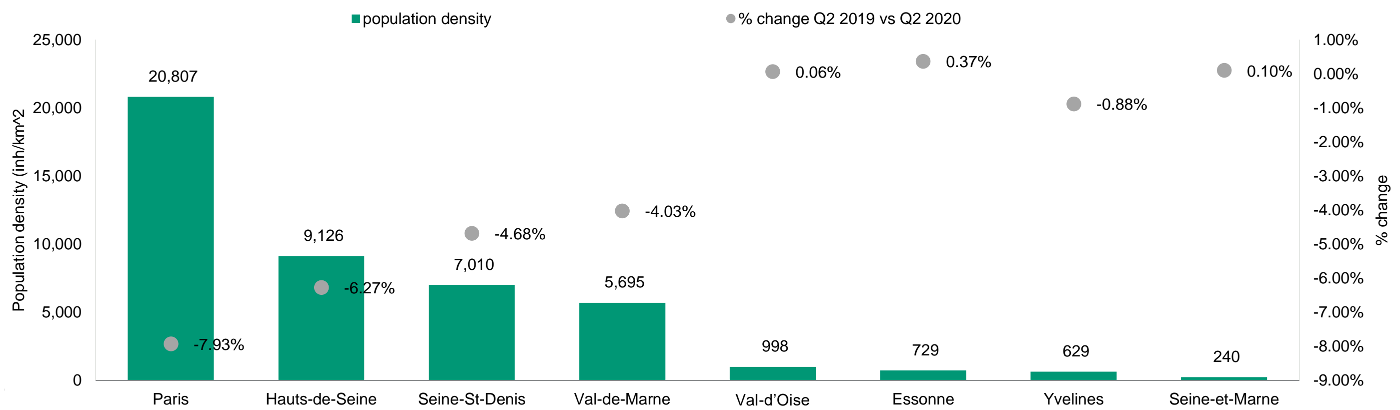
The growing prevalence of remote working because of COVID-19 and the decrease in affordability among workers employed in the most affected sectors will accelerate a shift in demand for housing away from densely-populated urban areas in Europe and toward smaller cities and suburbs.

COVID-19 has ingrained remote working as a viable option for many employers and employees. We expect many people and businesses will maintain flexible working arrangements in the aftermath of the pandemic, with some work from home rather than a full-time return to business premises.

As people spend more time working from home and away from offices, demand for housing within close proximity to major urban centers will decline meaningfully. Instead, buyers will increasingly look for larger housing that can accommodate home working further from city centres. The shift away from densely populated urban areas was already underway before COVID-19 and we expect this will accelerate in the wake of the pandemic. As an example, in the second quarter of 2020, home purchase transactions in Paris declined significantly more than in other less-densely populated areas, as Exhibit 7 shows.

Rising property costs because of urbanisation in big cities, as has occurred in Paris, will shift population groups towards small and medium-sized cities or suburbs that offer employment opportunities, connectivity and amenities in an urban, but more affordable environment. However, urbanisation trends will vary across Europe and we expect many major cities will continue to thrive by attracting and retaining citizens, given the cities' large higher education sectors, the availability of skilled jobs and by offering well-being in an urban environment. For example, we expect this will be the case for the largest cities in Germany.

Exhibit 7
Home purchases in Paris declined in the second quarter of 2020
% change in home purchase transactions, by city and population density (inhabitants per sq km)



Source: Moody's Investors Service, based on National Institute of Statistics and Economic Studies and other sources

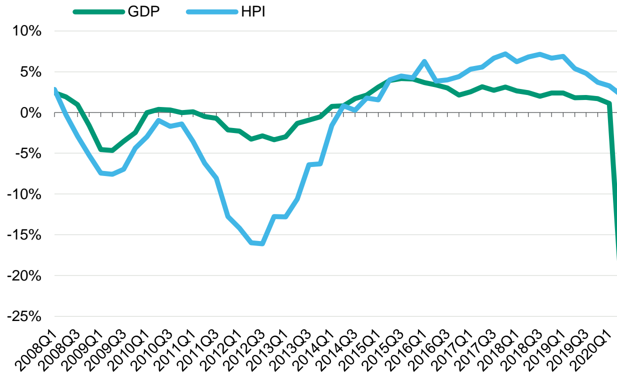
Following the 2008 global financial crisis, house prices in most European countries rebounded faster and with greater magnitude in central city locations than other parts of each country. This was driven by a recovery in local demand, but also an increase in foreign investment and local investors in the short-term letting business. This trend is unlikely to repeat if the demand in secondary cities and suburban area will continue to be strong after the pandemic ends.

Appendix

GDP and house prices changes for Western European countries

Exhibit 8

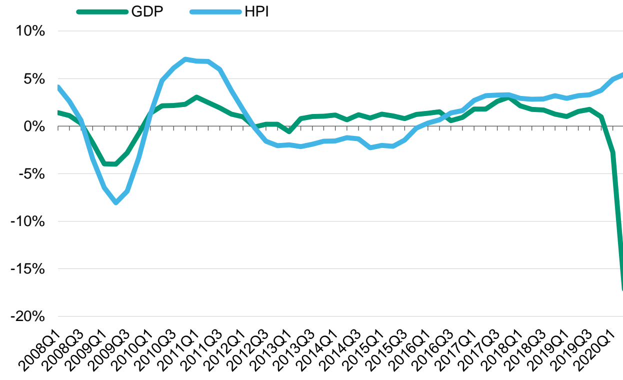
Spain GDP and HPI growth vs previous year



Source: Moody's Investors Service, based on Eurostat data

Exhibit 9

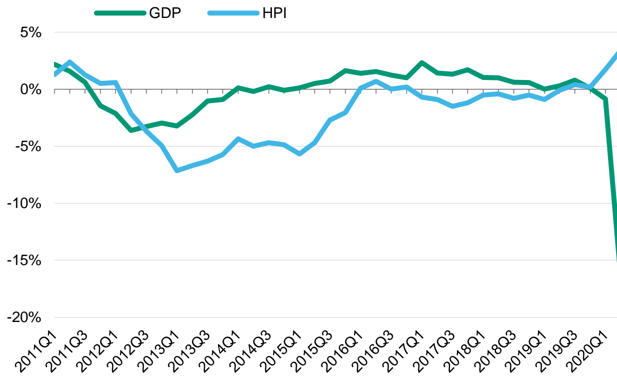
France GDP and HPI growth vs previous year



Source: Moody's Investors Service, based on Eurostat data

Exhibit 10

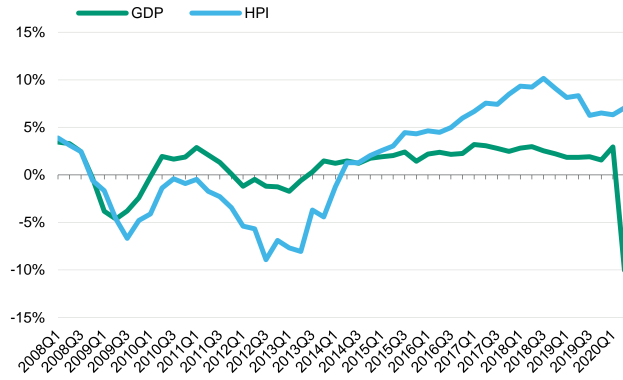
Italy GDP and HPI growth vs previous year



Source: Moody's Investors Service, based on Eurostat data

Exhibit 11

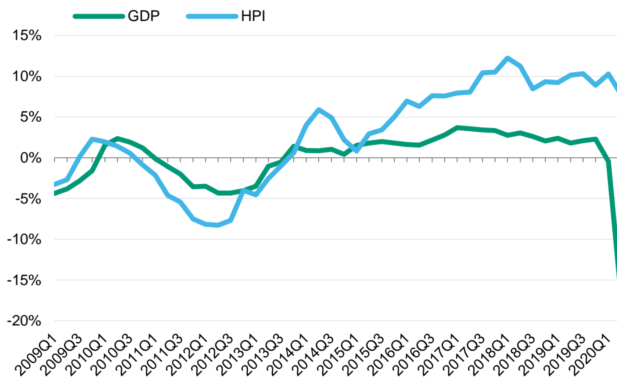
Netherlands GDP and HPI growth vs previous year



Source: Moody's Investors Service, based on Eurostat data

Exhibit 12

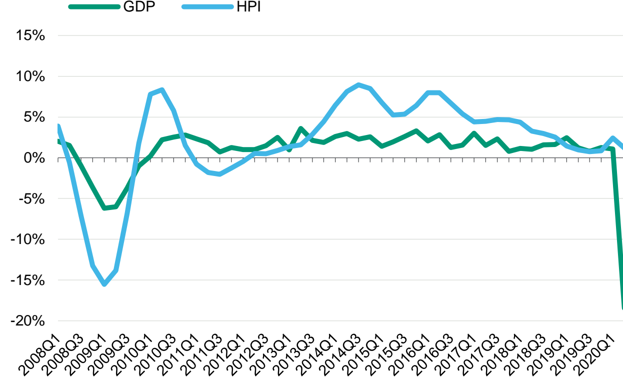
Portugal GDP and HPI growth vs previous year



Source: Moody's Investors Service, based on Eurostat data

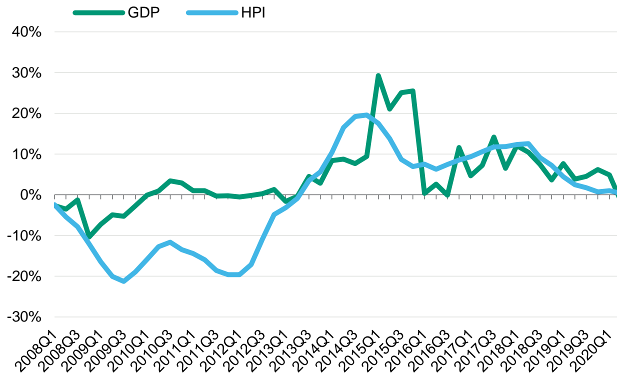
Exhibit 13

United Kingdom GDP and HPI growth vs previous year



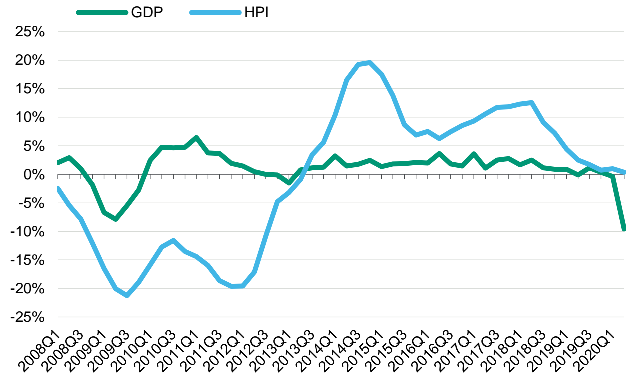
Source: Moody's Investors Service, based on Eurostat data

Exhibit 14
Ireland GDP and HPI growth vs previous year



Source: Moody's Investors Service, based on Eurostat data

Exhibit 15
Germany GDP and HPI growth vs previous year



Source: Moody's Investors Service, based on Eurostat data

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Endnotes

1 The scheme allows buyers to save 3% SDLT on purchase prices up to £500,0000. First-time home buyers were exempt from SDLT before the new government scheme, so home purchasing activity between July and October was largely led by more affluent buyer groups.

2 Source: The euro area lending survey.

3 Source: Bank of England.

4 Source: Bank of England

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